



The Axis of Oil

China and Russia find a new way to advance their strategic ambitions.

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A COLD WEATHER WAVE HITS America's northeast, oil inventories are drawn down, and prices rise. A pipeline is blown up in Iraq, and prices rise even more. The OPEC cartel meets and agrees to cut back production, adding to price pressures. The government announces a rise in inventories, or weather forecasters predict a thaw, or the Saudis say they will step up oil production, and prices fall. All interesting, all important to those playing the oil market or running companies that rely heavily on oil as an input, or trying to predict the course of their economies.

But these hardy perennials of the business pages will soon seem trivial next to the structural changes occurring in the international oil industry. Start with the much-overlooked fact that President Bush's inaugural address was nothing less than a repudiation of a deal cut 60 years ago by President Franklin Roosevelt with Saudi king Ibn Saud. FDR took a detour en route to Washington from the Yalta conference to meet with Saud aboard the USS Quincy, anchored in the Great Bitter Lake in the Suez Canal. "The official record was surprisingly silent about what the two men said about oil," notes Daniel Yergin in his magisterial *The Prize: The Epic Quest For Oil, Money & Power*, and Roosevelt died before he could make a full report. But no one doubted that the president had pledged U.S. support for the Saudi regime in return for Saud's promise of a steady flow of oil onto world markets.

It is certainly arguable that the Saudis reneged on their end of the bargain long before Bush decided to consign the Bitter Lake arrangement to the dustbin of history. After all, their "guarantee" of a continued flow became inoperative when they joined the producers' embargo in 1973. More recently, they abandoned their reasonable-price pledge by allowing oil prices to shoot up without making any effort to expand production capacity. Nor can it be said that a regime that uses its oil revenues to fund the export of the virulent version of Islam that produced almost all of the terrorists who perpetrated the atrocities of September 11, and that pays bounties to the families of suicide bombers, is behaving in the way Roosevelt anticipated when he shook hands with Ibn Saud.

But if Saudi behavior is not a deal-breaker, George W. Bush's inaugural broadside against tyranny--against "governments with long habits of control"--certainly is, unless the long-

standing Bush family relationship with the Saudis trumps the president's pledge. If Bush means what he says, and he usually does, he cannot favor the existing regime over such reform elements as might begin to emerge in Saudi Arabia. The kingdom will remain an important supplier of oil to the U.S. and world markets, and America will remain an important consumer of that oil, but it will be barrels-for-dollars from here on out, with no hidden promises to shore up the Saudi regime unless those threatening to replace it are an even greater threat to American interests. Which should please those eager to distance America from the odious House of Saud.

But hold the applause. America remains highly dependent on Saudi oil, the production of which is controlled by state-owned Aramco, an instrument of the Saudi government's foreign policy. Aramco is about 20 times the size of BP or Exxon Mobil, the largest private-sector oil companies. And Aramco is only one of the increasingly powerful state-owned players that are putting America not only at an increasing economic disadvantage, but at risk of losing a good deal of its diplomatic leverage in Asia, Europe, and the Western Hemisphere.

The end, if that is what it is, of the U.S.-Saudi special relationship is only one of the profound changes that are occurring in the oil market. Other developments make a break with the Saudis even more risky than it would ordinarily be, as our supplies of oil become subject to a complicated set of international games. For we are witnessing what might be called the geopoliticization of the world's oil and gas industry.

Given past government interference, whether it was the Texas government trying to keep prices high by restricting output in the early days, or the OPEC cartel doing the same in recent times, it can't be said that the free play of supply and demand ever set prices in the oil market. But we are now seeing an even more profound uncoupling of the oil industry from anything resembling the model characteristic of market economies. Governments rather than traditional commercial enterprises are increasingly taking control. And those governments often have interests quite hostile to ours.

The Chinese are desperate to secure supplies of oil to sustain an economic growth rate that is crowding double digits and that converted them into a net importer of oil in 1993. That means, first of all, forging closer economic and political ties in the Middle East. The Iran-China Chamber of Commerce, established in 2000, reports that trade between the two countries totaled \$7 billion last year, a 25 percent increase over the previous year. But this is not the ordinary buying and selling of profit-driven companies. Instead, it is the result of state-owned companies in China buying oil from state-owned companies in Iran, in transactions aimed as much at mutual political advantage as at commerce. China buys oil and funds a U.S. adversary; Iran sells oil, and in return gets help with the nuclear weapons program that worries America. Score: Adversaries, 2; U.S., nil.

The China Petroleum & Chemical Company (Sinopec) also signed a 30-year natural gas purchase deal to help the mullahs get their gas industry moving and agreed to invest in

the development of the Yadavaran oil field in return for Iran's agreement to sell it 150,000 barrels per day of crude oil. So much for U.S. trade sanctions.

The advantages to Iran of closer ties with China are obviously not restricted to payments received for oil. As Gal Luft and Anne Korin pointed out last year in *Commentary*, China "has sold ballistic-missile components to Iran as well as air-, land-, and sea-based cruise missiles. . . . Even more significantly, China has provided Iran with key ingredients for the development of nuclear weapons," and China's Fiber-Home Communications Technology is building a broadband network in Iran.

When Sinopec agreed to spend \$300 million to develop natural gas resources in Saudi Arabia, "the deal raised eyebrows for its high risk and potentially low returns," reported the *New York Times*. Sure, the Chinese would like to find some natural gas. But most experts say that if Sinopec had to justify this transaction purely on commercial terms, as would an American company, the deal never would have been consummated. Or, as the *Wall Street Journal* puts it, "State-owned firms will have a higher risk appetite when buying assets than their listed counterparts." The Sinopec deal was aimed mainly at establishing a larger Chinese presence in the Middle East. And a market for products that are on America's list of embargoed items. The Sino-Saudi oil-for-arms trade has included the sale by China of ballistic missiles with a range of 1,800 miles and capable of carrying a nuclear warhead, according to Luft and Korin.

China clearly aims to position itself as an alternative to America as an ally and armorer of countries that oppose U.S. foreign policy. Amy Myers Jaffe, a fellow at the James A. Baker III Institute for Public Policy at Rice University, told the *New York Times* that the Chinese "tend toward countries where the U.S. has sanctions like Sudan, Iran and Iraq." She might have added that China also tends towards countries that are key suppliers of the oil that keeps the wheels of American commerce turning.

China is not confining the extension of its influence to the Middle East. The Western Hemisphere is also in its sights. Canadian prime minister Paul Martin just visited Beijing and came away with a broad-ranging deal to cooperate in a wide variety of energy projects, including plans for a pipeline and ports that would allow as much as one million barrels per day of oil from Alberta's tar sands to move to Canada's west coast for export to China. That's one-third of the oil that America has been hoping might in the future be available to it from Canada's tar sands.

And, as always, there was more to the deal than a mere commercial transaction between consenting nations. According to their joint communiqué, the Strategic Working Group set up by Canada and China will not only broaden their energy relationship. In addition, in what can only be a shot at Washington, "Canada and China share the view that the United Nations and other multilateral institutions have an essential role to play in the development of a peaceful, prosperous and sustainable world." Little wonder that American officials have announced that they are "monitoring the talks," diplomatese for "sweating profusely."

In Latin America, China has made a series of oil deals that extend its influence, and must have James Monroe spinning in his grave. President Hu Jintao has agreed to invest \$100 billion in Latin America in a variety of energy-related and other partnerships, as Latin American countries "try to lessen their trade dependence on the U.S.," according to reports in the *Wall Street Journal*.

Most threatening is the arrangement made with Venezuelan president Hugo Chávez, a man with close ties to Fidel Castro and who claims his country is under "a new U.S. imperialist attack." China has agreed to invest over \$400 million in Venezuela's oil and gas industry, and to buy 120,000 barrels of that country's fuel oil each month. Chávez had made it known that he plans to use the proceeds of his oil industry to fund sales of cheap oil to Castro, and he has not denied rumors that he plans to finance revolutionary groups in other Latin American countries. Moreover, he has announced that he is no longer bound by his exploration and development deals with American companies ConocoPhillips, Harvest Natural Resources, and ChevronTexaco, putting into question the reliability of supplies from Venezuela, which account for 15 percent of U.S. imports.

To top off all of this, CNOOC, China's third largest oil company, is preparing a series of acquisitions in Asia that will allow China to acquire the resources it needs to fuel its growth and extend its influence into countries in which its commercial presence has until now been insignificant. Most notable is a probable \$13 billion takeover of Unocal, to be followed by the disposal of Unocal's American assets but the retention of its substantial Asian properties.

MEANWHILE, VLADIMIR PUTIN has been developing what astute observer Roger Boyes calls "a new policy instrument" to reassert Russian power. That instrument is "the Russian gas and oil-exporting companies that already all but dominate Europe's energy supplies. . . . Gazprom has woven a web of energy dependencies from Turkey to Turkmenistan, from Berlin to Baku." According to the International Energy Agency, by 2020, natural gas will account for 62 percent of Europe's energy consumption, and Russia will supply two-thirds of that gas.

This domination has more than commercial consequences. When German chancellor Gerhard Schröder told a television audience that Putin is a "dyed-in-the-wool democrat," the uninitiated chuckled, but insiders knew that the chancellor was simply indicating that he is not prepared to bite the hand that controls the valves of the pipelines that warm his country. Germany already gets 35 percent of its oil and 40 percent of its gas from Russia, figures that will steadily increase as Germany pursues its policy of winding down its nuclear power industry. The head of one of the think tanks affiliated with the German government preferred to remain anonymous when he told the press, "Given Moscow's history of strong-arming neighbors, we might want to think whether we really want to be in such a relationship."

Russia also plans to use its ample reserves of oil and gas to extend its influence in Asia. It has already agreed to allow Japan to finance an oil pipeline from eastern Siberia to the Pacific, from where it can be transported to Japan. The line, to be built by Russia's

Transneft, will cover some 2,600 miles, cost \$11.5 billion (some put the price tag at closer to \$18 billion), and allow Russia to export to several Asian nations as well as Japan. This was no mere commercial transaction: Japanese prime minister Junichiro Koizumi led the lobbying team that persuaded Putin to select the route that Japan favored.

Perhaps most important is Russia's use of oil to cement relations with China, an emerging alliance the consequences of which Charles Krauthammer has already warned are dangerous to American interests. A few weeks ago Russian energy minister Viktor Krishtenko visited Beijing to discuss areas of mutual interest with his Chinese counterparts. Just how China's desire to secure supplies of oil and natural gas, and Russia's desire for new markets and strategic advantage, will play out is uncertain. But there is every sign that Russian fuel is starting to warm historically chilly Sino-Russian relations. Putin has offered the China National Petroleum Corporation a piece of Yukos, the Russian oil giant that produces 1 percent of the world's crude oil, and that Putin effectively renationalized by jailing its principal shareholder (a Putin political opponent), and then slapping the company with a bankrupting demand for back taxes. Since American companies would have loved to have a crack at an interest in Yukos, Putin's decision to freeze them out is widely seen as a political decision to express unhappiness with American criticism of his recent power grabs, as well as an opportunity to cement relations with China, with which Russia's Gazprom already has signed agreements to cooperate in oil and gas markets.

Once again, we are witnessing deals that are more political than economic. Putin's *siloviki*, which includes his old KGB chums, is now firmly in control of Russia's oil industry, and plans to use the nation's resources to further diplomatic as well as economic goals, with the former taking precedence over the latter if the two goals should clash. As the *Economist* put it in a story titled "KGB Inc.," "It is a quirk of Russian history that the country's best hope of recovering the influence lost by Moscow with the fall of the Soviet Union is through the energy business." Former spies and "Kremlin henchmen," the story continued, quoting Paul Collison, an energy analyst at Brunswick UBS (a Russia-focused investment house), will make decisions in the interests of "only one shareholder--the state."

Putin knows that Chinese president Hu Jintao is more than a little annoyed that, to cater to Japan, his Russian counterpart selected the Pacific port of Nakhodka as a pipeline terminus, rather than Daqing. He wants "to make amends with China," Michelle Billig, a political risk analyst with PIRA Energy Group, told the *International Herald Tribune*, which may explain Putin's offer to the Chinese of a branch connection with the pipeline joint-venture with Japan.

That same source quotes "a Western energy executive" who insisted on anonymity as saying, "My feeling is that this is all about leverage with the U.S." Russia doesn't need the financing or technology that China or Japan can provide--the United States could make both available if Russia were in search of the best source of these assets. For Putin, the heavy dependence of Europe on his nation's oil and gas resources gives him a nervous

Germany as a defender of his democratic credentials, and joint ventures with China convert a onetime antagonist with whom Russia shares a 2,500-mile border into, if not an ally, at least a partner with shared interests.

SO PICTURE THIS WEB OF INFLUENCE that is being woven by countries eager to constrain American power. Canada and China become joint venturers, as do Venezuela and China. Canada is America's largest source of imported oil, and Venezuela sells us the light, sweet crude oil that our refineries are best equipped to handle. This means that a significant portion of the incremental production from these countries--and perhaps some of what is now headed here--goes to China, rather than to the United States, as energy planners here have been assuming. More important, no one believes that these deals are strictly economic, or would meet shareholder approval were such a force present in China. These are deals by state agencies, designed to extend China's influence to corners of the world from which it has until now been absent.

China has also solidified relations with Iran and other countries on America's list of international pariahs, trading arms for oil, and using its financial clout to establish close diplomatic ties in the region that contains the largest reserves of oil and gas in the world.

Meanwhile, Russia is using its reserves to dominate the European energy market, and make Germany, France, and other countries heavily dependent on Putin's good will. Not that he would cut off supplies at the slightest provocation. He doesn't have to. All the Russian "dyed-in-the-wool democrat" has to do is rely on German and French self-interest to tip those countries to his side in any dispute with the United States, just as China can rely on Latin American countries that benefit from its billions of investment to give that fact some weight in formulating their foreign policies.

Add the emerging relationship of China and Russia, and you have something to worry about. But not, it seems, if you are in the Bush administration. The president has nominated Samuel Bodman as his second-term secretary of energy. Bodman is no doubt an estimable executive, but his only prior experience in energy markets came when he gassed up his car. Besides, his main assignment, other than tending to the security of our nuclear facilities, is to push the president's energy bill through Congress. And that bill contains no realistic provision to reduce American dependence on oil imports. Bush will use legislation that cannot be filibustered in an attempt to win his fight to open the Arctic National Wildlife Refuge (ANWR) to drilling, but even if he succeeds--which is doubtful--he will have added perhaps one million barrels per day to domestic supplies some two decades hence, by which time the Energy Information Administration estimates that oil consumption in America will be over 20 million barrels per day, of which over 15 million barrels will be imported. ANWR oil may some day come to more than a drop in the bucket, but it won't be enough to change the geopolitical consequences of American dependence on imports. Unless Bush's new coolness to the Saudi regime is accompanied by other policies to reduce the dependence that prompted FDR to strike a bargain with Ibn Saud in the first place, the president may wish he had limited the scope of his endorsement of democratic reform to countries that don't have any, or at least not much, oil under their soil. If we fail to reduce our reliance on oil, we will be obliged by

economic self-interest to defend the Saudi royal family if--more likely, when--its control over some 25 percent of the world's oil reserves comes under assault.

Meanwhile, no thought is being given to the massive restructuring that is occurring in the international oil industry. Russia and China are using state-owned companies that are not bound to profit-maximize to achieve their long-term goal of weaving a web of relationships that will stand them in good stead in any diplomatic confrontation with the United States. Whether America can continue to rely on its private sector to provide us with comparable clout is no longer certain. After all, when companies that have to maximize profits compete with companies that seek to maximize national influence and power, the latter will engage in projects that the former simply cannot.

It may well be that state-directed ventures will prove so costly as to become unbearably massive consumers of their nations' resources--in the past, most countries (France being an exception) sooner or later decided that "national champions" are expensive luxuries, and the Soviet Union did collapse under the weight of its noneconomic enterprises. But it would be comforting to know that somewhere in our government a small group of knowledgeable people is worrying about something more than how to squeeze a few barrels of oil out of the frozen north.

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